

Internal Audit



Business Entities Refund Review

June 17, 2010

Internal Audit Staff

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Audit Highlights

As part of the Financial Integrity and State Manager's Accountability Act Review for fiscal year 2006/2007, Internal Audit (IA) identified the Business Entities (BE) refunds workload as a high risk area due to the volume of transactions and large monetary amounts. As a result, IA decided to review BE refunds in a separate audit, which resulted in this BE Refund Review. The audit scope covered both automated and manual BE refunds issued during fiscal year 2006/2007.

Our review of the BE refund processes revealed no significant breakdown in the internal controls. However, we identified the following areas that could use improvements:

- Inadequate separation of duties in the processing of manual BE refunds and BE macros in the Business Entities Section (BES).
- Inefficient use of resources in the reconciling of BE refund claim schedule amounts to the manual BE refund amounts posted to the Business Entities Tax System (BETS).

Upon notifying BES, the Tax Systems and Applications Bureau (TSAB), and the Fiscal Controls Unit (FCU) about the above findings, they have proactively taken steps to improve the processing of BE refunds.

Auditee's Response(s)

Introduction



Business Entities Refund Review

June 17, 2010

To: Marlene White, Director
Processing Services Bureau

Vic Kotowski, Director
Tax Systems & Applications Bureau

Jeanne Harriman, Director
Financial Management Bureau

From: Philip Yu, Director
Internal Audit Bureau

Types of Business Entities (BE)

A “business entity” is a type of legal entity that may be subject to a tax imposed by the State or required to file an informational return by the State. The term BE includes any Partnership, Limited Liability Company (LLC), Bank, Corporation, or Exempt Organization. Business entities required to file tax returns with the Franchise Tax Board (FTB) include entities incorporated or organized in California, those doing business in California, and those deriving income from sources within California.

BE Refunds

During fiscal year 2006/2007, FTB issued approximately:

BE Refund Type	Volume	Amount
Automated	145,276	\$846,684,349
Manual	2,221	\$759,891,073

Refunds are issued to BE due to overpayment of tax. All refund warrants are issued by the State Controller’s Office (SCO) based on the refund information transmitted by FTB. There are three methods of processing BE refunds:

- Automated refunds (applicable only to Corporations) are processed by utilizing the Business Entities Tax System (BETS), the accounting system used by FTB, and the refund information is transmitted by tape to SCO. SCO’s role is to issue the refunds in the form of warrants.
- Semi-automated refunds (applicable to Partnerships and LLCs) are also processed by utilizing BETS. The refund information, however, is not sent by tape to SCO. Instead, the refund information is transmitted to SCO by means of manually typed claim schedules (listing the names of BE and respective refunds amounts), together with notices (to be sent with the refund warrants to BE).
- Manual Refunds are required when automated or semi-automated refunds cannot be processed by BETS due to system limitations or when it is necessary to expedite a refund due to extreme/extenuating circumstances.

Purpose

As part of the Financial Integrity and State Manager’s Accountability Act (FISMA) Review for fiscal year 2006/2007, Internal Audit (IA) identified BE refund workloads as a high risk area due to the volume of transactions and large monetary amounts. As a result, IA decided to review BE refunds in a separate audit, which resulted in this BE Refund Review.

Scope

The audit scope covered both automated and manual BE refunds issued from July 1, 2006 through June 30, 2007, the same period covered in the FISMA Review.

Objective

The objectives of this review were to verify:

- Refunds to various BE were issued accurately and timely according to the California Revenue and Taxation Code (CR&TC) Sections 19340 and 19341, FTB's Policy, and BES Procedure Manual.
- BE refunds were properly reviewed and approved before issuance according to current refund procedures.
- Recovery actions were initiated regarding erroneous BE refunds according to CR&TC Sections 19411 and 19057, FTB's Policy, and BES Procedure Manual.

Methodology

To achieve our audit objectives, Internal Audit conducted interviews and reviewed BE refund activities conducted by the following business areas:

Filing Division - Business Entities Section (BES)

- BES is responsible for processing BE tax returns, tax assessments, and refunds.

Technology Services Division - Tax Systems & Applications Bureau (TSAB)

- TSAB is responsible for providing technological support for BETS.

Finance and Executive Services Division - Fiscal Controls Unit (FCU)

- FCU is responsible for forwarding claim schedules and notices to SCO. On a monthly basis, FCU reconciles BE refund claim schedule amounts to the manual BE refunds posted to BETS.

Results

The following is the auditor's findings and recommendations. For additional details relating to findings and recommendations, see Appendix A.

F-1	Finding	Inadequate separation of duties exists over the review, approval and release of manual BE refunds less than \$250K.
	Recommendation	<ul style="list-style-type: none">• Technicians who initiate manual BE refunds should not have the authority to review, approve or release any refund.• Only leads, supervisors, or authorized reviewers should have the authority to review, approve, and release refunds.• Revise BES Procedures to ensure adequate separation of duties exist over the manual BE refund process.
F-2	Finding	There is a lack of separation of duties over the BE macro process in BES.
	Recommendation	<ul style="list-style-type: none">• The same employee who creates/modifies BE macros should not test, deploy, store, or maintain the macros, nor should they have the capability to perform, review, or release on-line transactions in BETS.• All BE macro requests/modifications, acceptance testing, deployments, storage, and maintenance should be properly documented, authorized with sign-off signatures, and have audit trails.• BES should secure and restrict BE macro file on the shared drive to authorized personnel.• BES and TSAB should implement a service level agreement to outline agreed upon roles and responsibilities relating to BE macros.• All existing BE macros should be reviewed, tested, and approved by TSAB.

Results (Cont.)

F-3	Finding	Significant resources were spent by FCU and TSAB on reconciling BE refund claim schedule amounts to the manual BE refund amounts posted on BETS.
	Recommendation	<p>BES should:</p> <ul style="list-style-type: none">• Educate and train staff processing manual BE refunds to identify and resolve any monetary discrepancies prior to sending the BE refund claim schedules to FCU. <p>FCU should:</p> <ul style="list-style-type: none">• Send all manual BE refund discrepancies back to BES for correction regardless of the amount. <p>TSAB should:</p> <ul style="list-style-type: none">• Discontinue performing data fixes on manual BE refund discrepancies under \$100.

Conclusion

For fiscal year 2006/2007, FTB successfully processed approximately 147,497 automated and manual BE refunds. Except for the findings listed above, our review of the BE refund process revealed no significant breakdown in the internal controls.

Based on our review and evaluation of the BE refund processes, we conclude that the internal controls are sufficient to meet the audit objectives stated above as of the last day of field work, February 25, 2010.

Updates

We acknowledge and recognize BES and TSAB has made several process improvements prior to the completion of this review. These improvements include:

- All manual BE refund transactions, regardless of any dollar amount, are required to be reviewed and released by a lead or authorized reviewer, other than the individual who performed the original transaction.
- BE macro acceptance testing is being conducted by programming staff in TSAB.
- BES is documenting all BE macro requests/modifications, approvals, and sign-off signatures.
- BES secured and restricted BE macro file on the shared drive to authorized personnel.

Please inform Internal Audit in writing, of your efforts to implement the recommendations after 60 days, 6 months, and 1 year from the date of this final report. The information you provide us will be used to determine the need for a follow-up review.

Internal Audit greatly appreciates the cooperation and assistance provided by the management and staff within BES, TSAB and FCU. If you have any questions, please contact Dina Felisilda at (916) 845-6234, Wendy Lahey at (916) 845-7821 or Celece Anderson at (916) 845-3721.

Philip Yu, Director
Internal Audit Bureau

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Appendix 1



Findings and Recommendations

Finding 1 (F-1)

Inadequate separation of duties exists over the review, approval, and release of manual Business Entities (BE) refunds less than \$250K.

Condition

During fiscal year 2006/2007, the Franchise Tax Board (FTB) issued approximately 2,200 manual BE refunds totaling over \$760 million.

The Business Entities Section (BES), the section responsible for processing BE returns, payments and refunds, has implemented controls over the review process to ensure manual BE refunds are processed accurately and efficiently. The controls as stated in the BES Procedure Manual are as follows:

Level	Reviewer	Approves & Releases
1	Technicians not subject to 100% review*	Refunds less than \$250K with no account adjustments.
2	Lead or Technician not subject to 100% review*	Refunds with account adjustments \$5K or greater.
3	Analyst, Auditor, Supervisor, or Manager	Refunds more than \$250K
4	Technicians not subject to 100% review* and Supervisors	Refunds more than \$250K to the extent of 10% of the total volume of these transactions (Miscellaneous random review).

* 100% review is completed by a lead or an authorized reviewer.

Upon confirmation with BES, Internal Audit verified that:

- Level 1 allows the same technician to initiate, review, approve, and release refund transactions for less than \$250K.
- Level 1 review is incompatible with the separation of duties principle, a basic control that prevents or detects errors and irregularities by assigning responsibility for initiating, reviewing, approving, and releasing transactions to separate individuals.

Criteria

State Administrative Manual Section 8080, Separation of Duties, requires that the head of each state agency establish and maintain an adequate system of internal control within their agencies. A key element in a system of internal controls is separation of duties. This section provides the appropriate level of separation of duties for agencies with manual accounting processes.

Effect	The current BES procedure lacks appropriate review of BE refund transactions; therefore, increasing the potential for errors, irregularities, and fraudulent manual BE refunds.
Cause	The current BES procedures do not provide the appropriate separation of duties for the review, approval, and release of manual BE refunds.
Recommendation	<ul style="list-style-type: none"> • Technicians who initiate manual BE refunds should not have the authority to review, approve, or release any refund. • Only leads, supervisors or authorized reviewers should have the authority to review, approve, and release refunds. • Revise BES Procedures to ensure adequate separation of duties exist over the manual BE refund process.
Update	As of December 2009, all manual BE refund transactions, regardless of any dollar amount, are required to be reviewed and released by a lead or authorized reviewer, other than the individual who performed the original transaction.

Finding 2 (F-2)

There is a lack of separation of duties over the Business Entities (BE) macro process in the Business Entities Section (BES).

Condition

The Business Entities Tax System (BETS), the accounting system for processing BE transactions, has many system limitations and is very inflexible in its processing of BE returns. Thus, it creates a huge backlog of unprocessed BE returns, as the Franchise Tax Board (FTB) handles and processes over one million corporate returns annually. BES had requested BETS system changes to process those BE returns automatically. Unfortunately, the Tax Systems & Applications Bureau (TSAB), the bureau responsible for providing technological support for BETS, did not have the resources to make the programming changes.

To expedite the processing of the backlog, a staff member within BES developed various BE macro processes to serve as a workaround to process these BE returns. A macro, as defined by Microsoft, is a series of commands and instructions that a user can group together as a single command to accomplish a task automatically. BES currently has developed 78 macro processes for processing BE returns and performing various transactions within BETS.

During our review, the auditors identified that:

- The employee in BES who develops/modifies BE macros also tests, stores, and maintains the macros.
- No formal documentation or audit trails exists for these macro creations, acceptance testing, approval, deployment, storage, and maintenance.
- The file on the shared drive that stores BE macros is vulnerable to unauthorized access and manipulation.

Criteria

FTB's Information Security Policy File 9500:

Section 135 Information Security Principles states, "FTB shall apply the principle of separation of duties to reduce risk of fraud or misuse of information resources."

Section 205 Access Management states, "Information owners must identify and document conflicts of interest of specific business functions based on the principle of separation of duties."

Effect

Without separation of duties over the BE macro process, inappropriate macros could either be inadvertently or deliberately implemented with malicious codes, which may perform fraudulent transactions in BETS.

Cause

BES is unaware of the necessity for separation of duties throughout the macro process.

Recommendation

We recommend the following:

- The same employee who creates/modifies BE macros should not test, deploy, store, or maintain the macros, nor should they have the capability to perform, review, or release on-line transactions in BETS.
- All BE macro requests/modifications, acceptance testing, deployments, storage, and maintenance should be properly documented, authorized with sign-off signatures, and have audit trails.
- BES should secure and restrict BE macro file on the shared drive to authorized personnel.
- BES and TSAB should implement a service level agreement to outline agreed upon roles and responsibilities relating to BE macros.
- All existing BE macros should be reviewed, tested, and approved by TSAB.

Update

The following business process improvements have been made:

- As of March 2009, staff within TSAB is now conducting BE macro acceptance testing.
- BES is recording and tracking all BE macro requests/modifications, approvals and sign-off signatures.
- BES secured and restricted BE macro file on the shared drive to authorized personnel.

Finding 3 (F-3)

Significant resources were spent by the Fiscal Controls Unit (FCU) and the Tax Systems & Applications Bureau (TSAB) on reconciling Business Entities (BE) refund claim schedule amounts to the manual BE refund amounts posted on Business Entities Tax System (BETS).

Condition

For fiscal year 2006/2007, the Franchise Tax Board (FTB) issued approximately 2,200 manual BE refunds. On a monthly basis, FCU reconciles BE refund claim schedule amounts to the manual BE refunds posted to BETS by the Business Entities Section (BES).

During our review, Internal Audit identified:

- 93 accounts each had monetary discrepancies under \$100. The majority of the discrepancies were under \$0.05.
- 4 accounts each had monetary discrepancies over \$100.

Although the discrepancies were minor, FCU's past business practice involved reconciling each account to the penny until all discrepancies were eliminated. To resolve discrepancies, FCU would send the accounts to the following areas:

- Discrepancies under \$100 were sent to TSAB, where programmers reconciled the differences by fixing the data in BETS to match the BE refund claim schedule amount. Each data fix performed required approximately 4 hours to complete.
- Discrepancies over \$100 were sent to BES for correction, where technicians reconciled the differences by performing account analysis and making adjustments in BETS.

Once the business areas informed FCU that the discrepancies were resolved, Fiscal Controls completed the monthly reconciliation process.

Criteria

BES Procedure Manual 8100 Section 060 states, "Quality review will be performed on manual refund transactions that include offsets and/or interest allowed, regardless of the overpayment amount, to ensure that BETS transactions are performed correctly and will balance with Fiscal Controls".

Effect

- An additional workload was created for FCU who prepared discrepancy spreadsheets, gathered copies of notices, and data to be sent to TSAB.
- Monthly reconciliations were left open for extended periods of time pending actions by BES and/or TSAB.
- In order to resolve each of the 93 discrepancies under \$100, TSAB would have taken approximately four hours per account (372 programming hours) to analyze the account and fix the data in BETS.

Cause	BES staff processing manual BE refunds failed to identify and correct monetary discrepancies before sending BE refund claim schedule to FCU.
Recommendation	<p>BES should:</p> <ul style="list-style-type: none"> Educate and train staff processing manual BE refunds to identify and resolve any monetary discrepancies prior to sending the BE refund claim schedule to FCU. <p>FCU should:</p> <ul style="list-style-type: none"> Send all manual BE refund discrepancies back to BES for correction regardless of the amount. <p>TSAB should:</p> <ul style="list-style-type: none"> Discontinue performing data fixes on manual BE refund discrepancies under \$100.
Update	BES resolved the four accounts with monetary discrepancies over \$100.

Appendix 2



Responses to Recommendations

Finding 1 (F-1)

Inadequate separation of duties exists over the review, approval, and release of manual Business Entities (BE) refunds less than \$250K.

Recommendation

- Technicians who initiate manual BE refunds should not have the authority to review, approve, or release any refund.
- Only leads, supervisors or authorized reviewers should have the authority to review, approve, and release refunds.
- Revise BES Procedures to ensure adequate separation of duties exist over the manual BE refund process.

BES Response:

BES has changed procedures to require all manual BE refund transactions, regardless of any dollar amount are required to be reviewed and released by a lead or authorized reviewer, other than the individual who performed the original transaction. An authorized reviewer includes a designated reviewer, leads, analysts, auditors, supervisors and managers. The BES Procedure Manual update is in process.

Finding 2 (F-2)

There is a lack of separation of duties over the Business Entities (BE) macro process in the Business Entities Section (BES).

Recommendation

- The same employee who creates/modifies BE macros should not test, deploy, store, or maintain the macros, nor should they have the capability to perform, review, or release on-line transactions in BETS.

BES Response:

As of December 2009, the separation of duties over the BE macro process in BES has been implemented. The following chart displays the change in work processes that will ensure separation of duties.

Activity	Responsibility
Analysis of request	BES Analyst 1
Development	BES Analyst 1
Testing	BES Analyst 2
Acceptance Testing	TSAB
Deployment	BES Analyst 2
Maintenance	BES Analyst 2

We completely agree with Internal Audit's concern that BES employees involved in the macro process should not also have the capability to perform, review, and release on-line transaction in BETS. We are constrained by limited resources and knowledge specific to our program area and applications. However, effective immediately, we will begin cross training staff and anticipate we will fully comply with the Internal Audit recommendation in 9 to 12 months.

Recommendation

- All BE macro requests/modifications, acceptance testing, deployments, storage, and maintenance should be properly documented, authorized with sign-off signatures, and have audit trails.

BES Response:

As of February 2010, BES has implemented a formal macro log to track all BE macros requests, approvals, incidents and modifications. The log is stored on the standard shared drive for viewing and maintenance.

Finding 2 (F-2) Cont.

Recommendation

- BES should secure and restrict BE macro file on the shared drive to authorized personnel.

BES Response:

As of February 2010, BES has secured and restricted BE macro files on the shared drive to authorized personnel only. In addition, the password to the files is locked in a secure location with access by the Section Manager and Assistant Section Managers only in the event of an emergency and the analysts are not available.

Recommendation

- BES and TSAB should implement a service level agreement to outline agreed upon roles and responsibilities relating to BE macros.
- All existing BE macros should be reviewed, tested, and approved by TSAB.

BES Response:

Effective March 2009, BES and TSAB procedures were been revised for TSAB to review and perform acceptance testing on all BE macros prior to deployment into BETS production environment.

TSAB Response:

- TSAB is in agreement with comments on Macro's created by BES.
- TSAB will create a Request For change (Documents Audit Trail) when notified by BES for any new Macro.
- We will then meet with BES and perform Acceptance Testing and review of the Macro before approving release to production.
- This process has been fully implemented and running smoothly.

Finding 3 (F-3)

Significant resources were spent by the Fiscal Controls Unit (FCU) and the Tax Systems & Applications Bureau (TSAB) on reconciling Business Entities (BE) refund claim schedule amounts to the manual BE refund amounts posted on Business Entities Tax System (BETS).

Recommendation

BES should:

- Educate and train staff processing manual BE refunds to identify and resolve any monetary discrepancies prior to sending the BE refund claim schedule to FCU.

BES Response:

As of February 2010, BES procedures were revised to require all manual refunds to be posted to the Business Entities Tax System (BETS) prior to submitting them for the claim scheduling process. If there is a discrepancy of less than \$1.00 for the amount to be refunded between BETS and the manual refund form (FTB 6848 or FTB 6848D), revise the form to match the accounting system. The manual refund form must be re-worked if the discrepancy between the manual calculation and the accounting system is greater than \$1.00. FCU currently sends BE refund discrepancies to BES for correction.

BES also receives manual refund forms from the enterprise. To ensure consistency, we shared this information at a recent BE User meeting that is comprised BE representatives that request manual refunds.

BES General Comments:

Prior to July 2009, BES' inventory management process was a manual, labor intensive process in a paper driven environment. BES generates high volume of refund transactions with large monetary amounts. The BE refund workload is already a high risk area and the antiquated BES inventory management process added to this vulnerability.

In an effort to mitigate risks and execute better internal controls, an automated inventory tracking system was implemented in July 2009. It provides an on-line workflow management tool, allowing users to get new work and maintain and manage their personal inventory. The system also allows supervisors and managers to quickly assess the total inventory, age of the inventory, identify and manage priorities and locate returns. The Business Entities Inventory Tracking System (BITS) has resulted in efficiencies and improvement to BES including:

- Providing the ability to identify and prioritize refund returns.
- Implementing a controlled review processes for large refunds or other returns meeting review criteria.
- Eliminating paper and automating inventory counts and reports.
- Automating the annual revenue estimation report.
- Real time volume for all workloads.

Finding 3 (F-3) Cont.

- Instant access to any return in the current inventory.
- Ability to assign or reassign any return in to an authorized user instantly.
- Online referrals and transfers with tracking capability.
- Ability to review all status changes to a return in our inventory.
- Historical record of all returns worked by a specific user.

Recommendation

FCU should:

- Send all manual BE refund discrepancies back to BES for correction regardless of the amount.

FCU Response:

The process of submitting BE refund reconciling items to TSAB for items under \$100 and all other reconciling items to BES was established over ten years ago with BES and TSAB. After reviewing the findings and recommendations for process changes provided in the audit report, we agree with the above recommendation for the FCU's Business Entity Manual Refund Reconciliation.

- As of March 2010, the FCU's reconciliation procedures were changed. All BE manual refund reconciling items, regardless of dollar amount, are now sent to BES for correction. Once implemented, this change, along with other recommendations listed in the audit report, will decrease the number of reconciling items held open in FCU's BE refund reconciliation.

Recommendation

TSAB should:

- Discontinue performing data fixes on manual BE refund discrepancies under \$100.

TSAB Response:

TSAB is in agreement and appreciates the IA finding/recommendation that we should discontinue performing data-fixes on manual refund discrepancies under \$100.00.

- **Internal Audit** is an integral part of Franchise Tax Board's business operations. We were established in 1981 by the Executive Officer to audit FTB's business functions.

We provide recommendations to the Audit Committee and senior management to improve operations and mitigate overall risk exposure. We are also the liaison between FTB and external auditors.